ECONOMISTS' OUTLOOK

The US Housing Market is a Mess – Super Cheap Mortgages of the COVID Era Are Mostly to Blame This Time

John Yozzo, Managing Director, FTI Consulting, New York, USA

Synopsis

Home ownership has always been the cornerstone of the proverbial American Dream and the means by which most middle-class Americans have built personal wealth for decades. The formula has been straightforward: Save up for a downpayment, buy a house, make your mortgage payments on time, build up equity as home prices gradually appreciate, and finally, sell your home years or decades later for a tidy profit. It was a nearly foolproof way to accumulate some wealth over time, accessible to most working families for several generations and often constituted the bulk of their retirement wealth. But for nearly two decades homeownership has become a growing source of financial stress for many US households and increasingly a dream deferred for first-time home buyers. Yet for longtime homeowners in attractive markets, it is proving to be a veritable goldmine as never before when it comes time to cash out. It is a complicated story of a once predictably stable housing market upended by years of underinvestment in new housing, age-related demographic shifts, and well-intentioned policy actions with distorting effects, resulting in unanticipated demand booms and recent supply shortages. Consequently, average Americans are paying more than ever for a home relative to their income, a trend that has steadily worsened for several decades. Moreover, the number of home sale transactions has plummeted since mid-2022 to levels not seen since the Great Recession and its aftermath, as more homeowners with cheap mortgages choose to stay in place. Aspiring homeowners are forced to choose between paying top dollar for a piece of the Dream or staying in a rental market that is increasingly expensive as well. It is hardly a dreamlike state. High shelter costs, either as an owner or tenant, are a big cause of financial anxiety for a majority of Americans who continue to express dissatisfaction with the state of the economy to pollsters.

The housing sector is not an industry per se. Overwhelmingly it consists of Americans selling homes to each other. (New homes consistently account for less than 15% of total single-family home sales in any year.) However, its wider economic impact is huge, ranging from homebuilders and subcontractors, realtors, mortgage providers, and home furnishing and improvement retailers. Consequently, the health of the housing market often reflects the condition of the broader consumer economy. That seems especially apt these days, with the high end of the housing market operating in a rarefied realm of its own while the rest of the market struggles to find a healthy balance.

A brief history of the US housing sector in the 21st century

The infamous housing bust of 2007-2012 is by now a legendary story, chronicled in great detail in countless articles and a best-selling book by Michael Lewis that spawned a star-studded Hollywood movie, *The Big Short*. Perhaps in time the forces that have prevailed in the US housing market since 2020 will be viewed as no less unsettling, though of an entirely different nature.

The housing boom of the early 2000's and ensuing bust that preceded (some would say ignited) the global financial crisis of 2008 is well covered ground to which there is little new insight to add, though its backdrop is often overlooked. *America's Homeownership Challenge*, an initiative laid out by President George W. Bush in June 2002,[1] encouraged the banking and real estate industries to make home ownership more accessible, especially for minorities and lower income families, and provided various tax and monetary incentives to eligible buyers, lenders, and home developers to facilitate this goal. It was part of broader directive under the Bush administration, often referred to as the Ownership Society,[2] which advocated that home

Notes

1 President Calls for Expanding Opportunities to Home Ownership, Office of the White House, 17 June 2002, 'President Calls for Expanding Opportunities to Home Ownership' (archives.gov).

2 America's Ownership Society: Expanding Opportunities, Office of the White House, 9 August 2004, 'Fact Sheet: America's Ownership Society: Expanding Opportunities' (archives.gov).

Exhibit 1: US Homeownership Rate

Source: US Census Bureau

ownership, indeed any property ownership, helped individuals build personal responsibility and other virtuous behaviors that strengthened families and benefited our country.

Ironically, this admirable initiative arguably helped soften the ground for the calamity that was to follow: a surge in home sales and housing prices through 2006, largely enabled by lax lending standards, massive mortgage securitisations and reselling by originators ("de-risking"), "no money down" (or little money down) mortgage qualification, no income verification loans ("liar loans"), a surge of risky subprime mortgages and adjustable rate mortgages, house flipping hobbyists, easy home equity extraction loans and HELOCs, deteriorating loan-to-value ratios, and ultimately, a whole lot of home owners who could not afford their monthly payments once the music stopped playing. This culminated in a mortgage delinquency rate on single-family homes topping out at an unprecedented 11% in 2010 and exceeding 10% through 2012,[3] coinciding with widespread mortgage defaults and home foreclosures. So much for the virtuous effects of the Ownership Society. The housing bust was a ruinous episode for many defaulting homeowners and profligate lenders, and set the stage for the wider financial crisis that soon followed.

The US home ownership rate, which climbed steadily during the 1990s from 64% to 67% by the end of the century, moved to an all-time high of 69.2% in 2004 near the pinnacle of the housing boom. Existing home sales peaked at an annualised rate of 7.25 million in mid-2005 – easily an all-time high – only to crater 44% from there, to 4.1 million homes in 2008, a depressed range where it was stuck for the next four years. This boom-and-bust cycle was primarily a demand-driven phenomenon led by market conditions that made it too easy to purchase and finance a home or engage in speculative home buying and drove up home prices beyond traditional affordability levels until it came crashing down.

By 2011, the homeownership rate fell back to 66% and bottomed at 62.9% in 2016 – the lowest ownership rate since the Census Bureau began tracking it in 1966 – before recovering since then (Exhibit 1), and currently sits near its long-term average of 65%. The vacillation in homeownership rates this century might not seem significant, but each one percentage point change represents approximately 1.2 million homes. Such volatility in homeownership is unprecedented and hasn't settled down much in recent years despite the appearance of relative stability compared to that tumultuous first decade.

In retrospect, the lax lending practices, easy mortgage qualification and soaring home prices of the early-to-mid-2000s rightfully is called a housing bubble, though that label is not heard to describe these times even as national home price gains in 2020-2021 surpassed those of the housing boom and continue to climb despite high mortgage rates. Then again, few pundits were invoking the term "housing bubble"

Notes

3 Consumer Affairs, *Journal of Consumer Research*, 'Mortgage Delinquency Rates 2024'.

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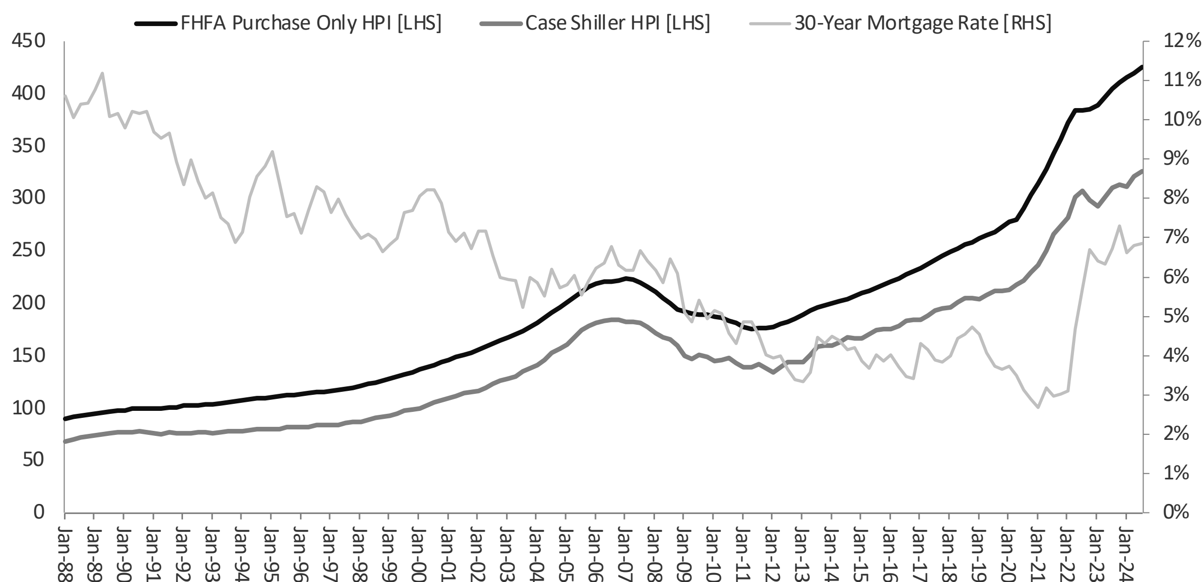
Exhibit 2a: Home Price Indexes (Index Value)



Source: FRED, the Federal Reserve Bank of St. Louis

back in 2005. Such phenomena are most evident and best understood in hindsight. Moreover, the current housing market imbalance causing home prices to soar since 2020 is mostly attributable to a collapse in supply, whereas events labeled as bubbles or manias typically are caused by irrational or unsustainable demand, which is not the driving force at the moment.

A general factor contributing to housing market turbulence is a slowing of new homes built since 2008 combined with pronounced demographic changes this century. This topic often gets attention under the broader discussion of lack of affordable housing, a cause of which is a shortage of new housing generally. Total US housing units have increased by 26% cumulatively since 2000, or about 0.9% annually, with unit growth especially depressed between 2009-2016. Moreover, there are age-related demographic factors at work too that amplify the impact of this trend, with the number of Millennials in the prime of adult life now outnumbering the size of wizened Baby Boomers by nearly 10 million. This implies an acute need for more housing and has contributed to a shortage that cannot be addressed timely enough to meet the need. It would take years of accelerated growth in new housing to make up lost ground from underinvestment and demographic shifts. But these trends, however concerning, distract from the main causes of housing market disequilibrium and price spikes since 2020, which are primarily attributable to the COVID-19 pandemic and the Federal Reserve's response to it.

Home prices: double, double, toil and trouble

It is always a slippery exercise to generalise about housing prices nationally given the formidable regional market dynamics that differentiate local markets from widely used measurements of a national home price average. Like the adage about politics, all housing markets are local – and regional. However, national home price data still is directionally indicative of housing market conditions despite these considerations. In particular, the S&P CoreLogic Case-Shiller National Home Price Index (CS_HPI) measures home prices using only repeat home sales (or paired sales of the same home over time), which mitigates concerns that measuring average sales prices of all homes nationally is unduly influenced by where sales occur. CS_HPI is considered the preeminent gauge of US home prices, and we used it going back to 1988, as well as the Federal Housing Finance Agency House Price Index (FHFA_HPI), which also uses a repeat sales methodology on a larger dataset than CS_HPI, to evaluate national home prices changes over nearly four decades. Currently, the CS_HPI and FHFA_HPI are at all-time highs, having accelerated since 2020 but not retreating even when mortgage rates doubled under QT monetary policy (Exhibit 2a).

Both these home price indexes produced eight consecutive quarters of double-digit price gains (YoY) from late 2020 through late 2022, including four straight quarters of near 20% gains (YoY) from mid-2021 through mid-2022. Such outsized price appreciation exceeded comparable prices gains at the height of the previous housing boom (Exhibit 2b). Moreover, average annual home prices appreciation

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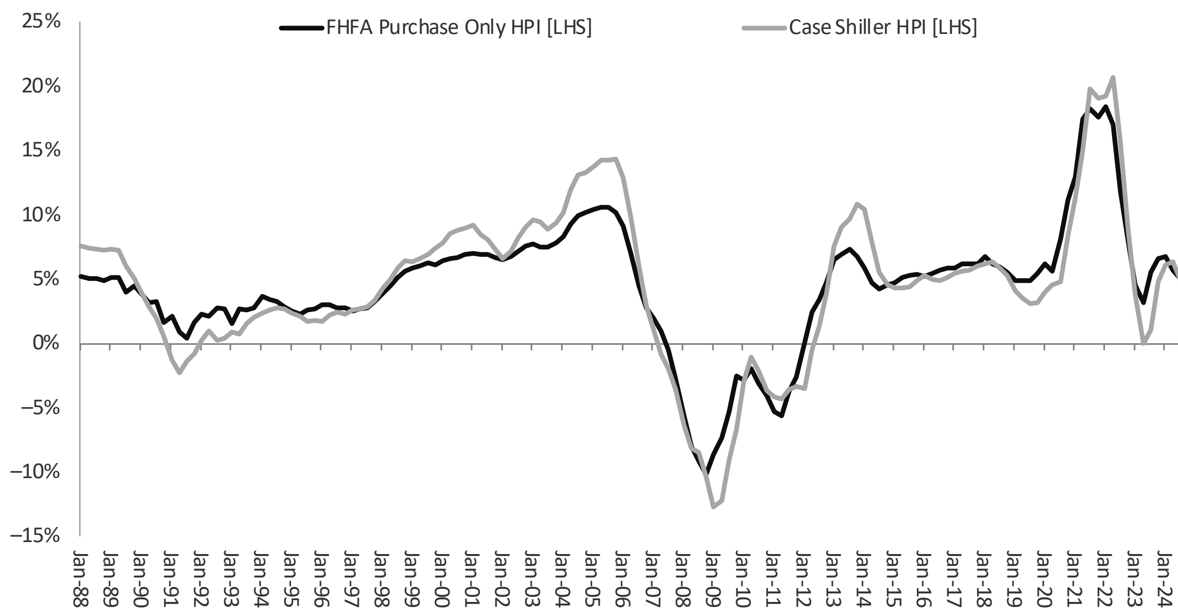
Exhibit 2b: Home Price Indexes (YOY %age Change)



Source: FRED, the Federal Reserve Bank of St. Louis

this past decade (2014-2024) of just over 7.0% is more than double average annual gains from 1990-2000 per both home price indexes.

Most surprising, neither home price index has produced an outright price decline (YoY) in any quarter since the Fed began its monetary tightening policy in March 2022 – a period during which average 30-year mortgage rates more than doubled, topping 7.0% in 4Q23. Certainly, home price gains have slowed (i.e., decelerated) since Fed tightening kicked in, but average home prices have continued to increase throughout this period even as an average monthly payment for a new home mortgage soared by nearly 50% from trough to peak once QT began. It defies economic logic.

But current record-high home prices come with a big asterisk: transaction activity has plummeted as potential home sellers stay on the sidelines rather than move and give up their ultra-low-rate mortgages. Home supply, that is the number of homes actively listed for sale, has shrunk significantly since 2021, propping up home prices but depressing sales activity. Existing home sales again will hover near 4.0 million homes this year, close to 2023 totals and far lower than the 6.1 million existing homes sold in 2021 and an annual average of 5.4 million homes sold from 2016-2019 prior to the pandemic.[4] Such depressed transaction activity approximates existing home sales totals from 2008-2011 when home sales averaged 4.2 million units annually amid the worst housing slump on record. Bloomberg's consensus forecast of economists expects 4.4 million existing home sales in 2025, a modest uptick from current depressed levels.

Using a reasonable (but imperfect) metric of relative home prices going back decades, Americans today are paying more than ever for their homes – nearly 5.5X median household income and 4.25X median family income (Exhibit 3).[5] Not surprisingly, these metrics were consistently lower for the 15 years that preceded the housing boom of the early 2000's and have steadily worsened since then. This relative home price metric is higher today than it was at the height of the housing boom in 2005 and there is little room for this metric to deteriorate further without inflicting onerous financial burdens on home buyers.

What is driving home prices higher in a high interest rate environment?

The initial cause of rising shelter (own or rent) prices since 2020 was the COVID-19 pandemic, which prompted millions of Americans to suddenly relocate, either temporarily or permanently, or to purchase second homes in non-urban locales. More importantly, the Fed's near-zero interest rate policy (N-ZIRP) in response to COVID-19 has impacted the housing market far longer than the pandemic did. In particular, N-ZIRP caused mortgage rates to plummet by 200 basis points

Notes

4 Statista.com, 17 April 2024, 'Forecast existing home sales in the U.S. 2025'.

5 A family is defined of a household with at least two resident adults and a child or other dependent person.

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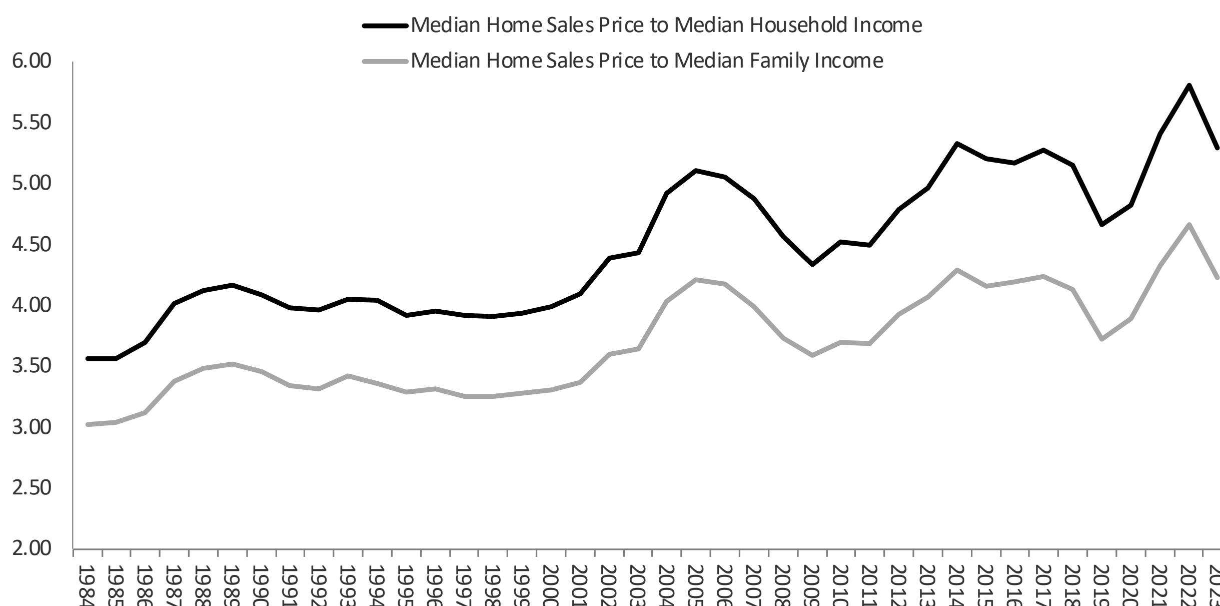
Exhibit 3: Home Prices Relative to Income



Source: FRED, the Federal Reserve Bank of St. Louis

in 2020-2021 compared to 2018, prompting buyers to bid up prices for homes due to lower monthly mortgage payments. Rather than making home ownership more affordable, record-low mortgage rates caused home price increases to accelerate, as buyers could afford to bid more for the same monthly payment. Mortgage rates remained near or below 3.0% through late 2021 while Fed open market securities purchases continued into early 2022, long after the worst impacts of COVID-19 on the domestic economy had passed.

More consequentially, N-ZIRP resulted in nearly 15 million households refinancing their home mortgages from mid-2020 through late 2021,[6] locking in ultra-low rates for years to come – the effects of which we are still contending with. Recent data from the Federal Housing Finance Agency indicates that 56% of homeowners with a mortgage enjoy a mortgage rate of 4.0% of less, and 22% (approximately 11 million homeowners) have a mortgage of 3.0% or less, with most locking in those low rates during the N-ZIRP period that ended by late 2021 (Exhibit 4). That latter group (3% mortgage rate or less) is 18 percentage points higher than it was at the end of 2019. These homeowners aren't going anywhere for a while.

In a normal functioning market, home prices would have fallen materially to offset soaring mortgage rates since 2022, with lower prices being the mechanism by which the market clears and supply/demand balance is restored. Not this time. Homeowners considering selling today would have to surrender their cheap mortgages and still pay top dollar for a new residence. That is a losing proposition for them, so millions of homeowners are choosing to stay on the sidelines rather than move, causing the supply of available homes for sale to plummet and maintaining upward pressure on home prices despite high mortgage rates.

The average inventory of existing homes listed for sale fell by 46% in 2023 compared to its pre-COVID average and has remained 34% below average to date in 2024. Supply has recovered modestly this year, as the cohort of retiring Baby Boomers downsizing their lives grows larger and more become home sellers. Other home sales closing for cash, estimated to be about 25% of transactions, also aren't as impacted by current market imbalances, as cash buyers are less sensitive to record-high prices and unimpacted by high mortgage rates. However, cash sales mostly occur in more affluent locales and overwhelmingly consist of repeat buyers, not first time buyers.

Many housing pundits have opined that the end of monetary tightening by the Fed and the presumption of more Fed rate cuts in the year ahead will bring down mortgage rates and stimulate home sales activity. Not so fast. Mortgage rates have eased by more than 100 basis points from their 2023 peak and currently hover near 6.25%. Curiously, the yield on the 10-year Treasury note – which is closely correlated with mortgage rates – has increased by 30 bps since the Fed's 50 bps rate

Notes

6 The Great Pandemic Mortgage Refinance Boom, Liberty Street Economics, 15 May 2023, 'The Great Pandemic Mortgage Refinance Boom – Liberty Street Economics' (newyorkfed.org).

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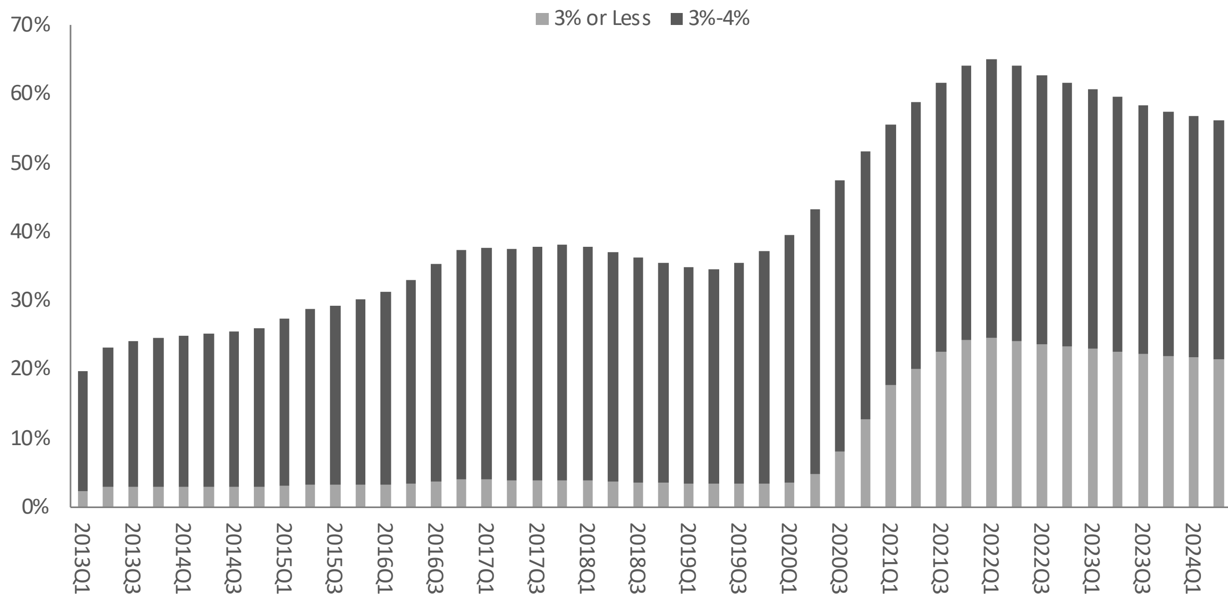
Exhibit 4: Percentage of Home Mortgages with Interest Rate of 4% or Less



Source: Federal Housing Finance Agency, National Mortgage Database

cut in September, as concerns linger about the pace of further Fed easing as well as growing credit market concerns about the size of federal budget deficits and debt outstanding, which markets recognise are poised to grow larger no matter who wins the presidential election. Those hoping for the return of a 5.0% mortgage in 2025 might be in for disappointment.

The concern here is that mortgage rates at or near 6.0% may draw out more frustrated buyers than anxious home sellers, most of whom still are sitting with much cheap mortgages in place. This dynamic could propel home prices still higher to the extent that lower (but still high) mortgage rates attract more buyers than sellers to transact. Lastly, owners who have become mentally anchored to record-high values for their home in the last couple of years have little incentive to make meaningful price concessions to close a sale.

Conclusion: supply-demand imbalances in the housing sector are likely to persist

The housing sector remains a seller's market with little indication of impending relief for prospective home buyers. The unintended consequences of the Fed's N-ZIRP during COVID-19 largely is to blame for the supply-demand imbalance in the housing market that will persist at least into 2025. Rather than making home ownership more affordable, ultra-low mortgage rates of the N-ZIRP period have had quite the opposite effect. As the old saying goes, the road to hell is paved with good intentions.

Apparently, these stark lessons are not necessarily learning moments for politicians and policy makers. On the campaign trail, Vice President Kamala Harris discussed the middle class struggle with affordable housing and home ownership, which is a very real problem, and floated the idea of a $25,000 interest-free loan from the federal government for qualifying first time home buyers, the premise being that saving enough for a down payment is the primary impediment for aspiring home buyers. As with the huge expansion of federally guaranteed student loans or the Bush administration's *Homeownership Challenge* initiative, such good intentions will not likely have their intended effect and are more likely to stimulate demand and lift prices further without improving the affordability issue.

The problem is obvious: Average home prices and monthly shelter costs (for owners and renters) are too high relative to income for most non-affluent Americans, a majority of whom continue to tell pollsters that the high cost of living still is hurting them despite inflation easing for months. High shelter costs are central to these persistent concerns. Within the basket of goods that comprise the US Consumer Price Index (CPI), the most prevalent gauge for measuring inflation at the consumer level, shelter now accounts for a 33.1% weighting in the index compared to 29.5% one decade ago, reflecting the creeping relative cost of housing in overall consumer spending. Moreover, the shelter component of the CPI remains the most inflation-stricken component of the consumer basket even as overall inflation moderates, with the CPI for shelter consistently increasing at nearly twice the rate

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of the overall CPI for the past year and still hovering above 5.0% YoY. Commodity prices may be easing for consumers as domestic economic growth slows but there is little sign of relief for record-high home prices and shelter costs, nor should any be expected as long as new home supply remains inadequate while millions of fortunate Americans with very cheap home mortgages continue to stay put.

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